1979

International standards: The search for a common denominator

Edward Weinstein

Recommended Citation

Tempo, Vol. 25, no. 2 (1979), p. 30-35

international standards

the search for a common denominator

by EDWARD A. WEINSTEIN/Partner, New York

The biblical story about the Tower of Babel attempts to explain the differences in language that exist among the peoples of the earth. "If this is what they can do as a beginning," the Lord is quoted, "then nothing that they resolve to do will be impossible for them. Come, let us go down, and there make such a babble of their language that they will not understand one another's speech."

Accounting, an evolving form of human communication, also differs throughout the world. Perhaps a vindictive God caused this when a group of accountants, meeting at some ancien convention, came too close to creating a truly uniform set of accounting principles. Of course, that is being facetious; but just as it has been difficult to sell Esperanto to the world, it will be difficult to sell a standardized set of accounting principles.

Indeed, it is my contention that attempts to harmonize accounting standards will not succeed. Although there may be some success in a broad sense, true harmony will never be achieved at the level of detail which would enable the consolidation of financial statements from different countries. An alternate approach is possible, however, and how it can work will be the subject of this article.

What are the significant obstacles to achieving a common denominator in international accounting and reporting? Regrettably, they have been minimized in the headlong plunge to achieve a utopian system. Indeed, it is so difficult to surmount these obstacles that there are real doubts that we should strive for such a system. The diversity of peoples, languages, cultures, political systems, and business practices which exist in the world's societies are a reality upon which such a system would probably founder—if, indeed, it could ever be constructed.

The Differences

That is why constructing such a system would be akin to reconstructing the legendary Tower of Babel. It cannot be done. Not because a deity has prevented it, but because fundamental natural differences, which create and sustain the diversity of accounting standards, are beyond our control. These differences are:

Local Laws. Even within the so-called English-speaking world, diversity is evident. In most of this world, for example, business operates under some form of the "Companies Act," which was originally formulated in Great Britain. These laws usually require an audit of each legally established corporation. Yet, within the United States, which has always been a part of the English-speaking world, the law evolved differently.

Not every corporation in the United States has to be audited. Some privately held corporations are not audited at all. Corporations related by ownership tend to be audited only as part of a controlled group. That simple difference reflects how distinctly we have viewed incorporation. The Commonwealth countries have tended to view it as a special privilege, subject to government scrutiny. In the United States, however, the differences among competing states, plus a laissez-faire policy, have prompted a view of incorporation which is almos nonchalant.

Customs and Social Mores. Customs and mores vary from country to country—and understandably so. From these differences have evolved a variety of business practices and accounting standards. For example, in Japan a sale is not considered to be consummated just because legal title has passed. Japanese companies bookkeep a sale when the product is shipped, but it is understood that the transaction is not complete until the customer is satisfied with the product.

Even if the product matches the

the search for a common denominator

buyer's specifications, he may negotiate a return if he is unable to use the product as profitably as he had thought he might. Japanese business people who read Japanese financial statements understand that relationship between the seller and his customer. The information needs to be understood, as well, by outsiders who evaluate a Japanese company.

Economics. The economics of countries like the United States and Zaire are radically different. So, too, are those of such countries as France and Chile, West Germany and Malaysia, Japan and Peru, or Bermuda and the Union of South Africa. These variations are the result of many influences:
—the natural resources that are available,
—the skills of the people,
—the political stability of the country.
When economic conditions vary, the evolution of the accounting profession varies as well.

Tax Policies. Tax laws profoundly influence the evolution of accounting standards. Tax laws of different countries vary dramatically, depending upon the needs of the country and the perceptions of its rulers. Frequently, tax laws are intended to affect social policy. Given the diversity of objectives within each country, it is understandable that tax laws throughout the world are diverse. Is it not equally understandable that accounting standards also, of necessity, are diverse?

Given the above—the differences in local laws, the differences in customs and mores, the diverse economic conditions, and the differences in tax objectives and policies—is it possible that a common accounting system could evolve among the many countries? Is it possible that a common system could be developed successfully, with even the most concentrated effort? It seems unlikely.

But there is another reason as well. Most corporations in the United States never publish financial statements. There are no laws which require them to do so. Financial statements are published by companies only when they seek credit, and their creditors demand them; or when a company's ownership becomes widespread, and stewardship reporting is required. In some instances, these financial statements may be audited; in others, they are not. But there are no laws or government regulations which require a financial statement from a private corporation to be either published or audited.

There are, of course, laws which govern the financial reporting of the large, publicly owned corporations in the United States. However, only the parent corporation is subject to the Securities Acts; and, therefore, no subsidiary corporation need publish financial statements, nor need it be audited. It is only the consolidated financial statements which need to be examined by a certified public accountant.

Although not unique, this set of regulations does set U.S. corporate existence apart from that of most other countries. It also means that accounting standards have evolved largely to satisfy the needs of the public investor—to help him view the financial statements of the large, publicly owned corporations.

In other countries of the world, however, financial reporting is required of a company simply as a result of its corporate existence. And it is natural that this reporting should be more compliance oriented, more socially concerned, more clearly influenced by tax considerations. In the United States, social accounting has been discussed but has never been given a high priority. Income reporting is designed to predict cash flows, rather than minimize taxes. Questions of legality are considered only to the extent that they might affect financial conditions.

The Impact

Thus, accounting standards are as diverse as our societies. And even if our societies move closer together, it is unreasonable to think that we can eliminate their fundamental differences. Not that we should abandon our efforts. For a number of reasons, the profession is deeply concerned about the impact of diverse accounting standards. Some of these reasons are:

The Political Climate. The debate over accounting principles offers, potentially, an attractive political payoff. Hence, government bodies are becoming attracted by the issue. In the United States, new legislation has been proposed to bring the standard setting process under government control.

Congress is attracted to the accounting area because of some dramatic corporate failures, as well as charges that companies have been able to manipulate accounting principles, either to hide operating losses or to transform them into profits. Our profession must demonstrate its ability to eliminate such diversity of accounting principles, if it is to retain its right to set any kind of standards.

In the international arena, the United Nations' Centre for Transnational Corporations has expressed concern about the lack of acceptable international accounting and reporting standards. It has proposed a comprehensive system of reports to be filed by all multinational businesses. The U.N. proposal represents a dramatic departure from any traditional reporting approach. It focuses on a number of difficult problems, including: measuring the fairness of intercompany pricing; reporting on employment situations; and anticipating the consumption of raw materials. We must, as an international profession, respond to the U.N.'s concern about abusive accounting practices. If possible, we must help them with their social reporting concerns. If we fail to act responsibly, we deserve to have them set standards for us.

Investor Confusion. The *Financial Times* publication, "World Accounting Report," presented a classic problem in diverse accounting standards. The report reviewed two British Petroleum prospectuses that simultaneously offered shares in the U.K. and the U.S.A. The earnings summary in the latter prospectus differed significantly from the earnings summary in the U.K. prospectus—the difference over five years amounting to hundreds of millions of pounds. For example, the treatment of foreign currency translation under U.S. standards reduced the petroleum company's 1976 income from £179.8 million to £53.8 million. Furthermore, in 1972 the U.K. financial statements omitted from net income a £274.5 million capital gain which is included in income under U.S. standards. Other major differences occurred in the accounting for pension costs and taxation. The report also pointed out significant differences in disclosure, even though each prospectus had the same objective.

Another issue of the same publication focused on multinationals in the motor industry. The 1976 financial statements of Volvo showed net income of $15 million under Swedish accounting. Under U.S. accounting standards, net income would have been $70 million. The difference is caused by several changes, including the elimination of reserves set up for tax purposes, provision for an item described as "work environment," inclusion of income from investments, and the consolidation of the results of associated companies.

A potential investor must surely be confused, and perhaps even discouraged, by such a wide disparity in reported results. These are not cases where the company is picking and choosing between the most advantageous principles, nor are they cases of different principles for different facts. These are cases where multinationals were forced to conform to two different sets of standards.

A New Approach

The international profession must continue to work on the problem of the diverse accounting standards which prevail around the world. Its approach should include three steps:

(1) Those responsible for developing international accounting standards should concentrate on broad, overall issues and stay away from specifics.

(2) All those in the international profession have an obligation to educate the users of our financial statements concerning the nature of the accounting process, and the degree to which it is influenced by the society in each of our countries.

(3) All of us must take an entirely new look at the traditional approach to reporting on the financial statements of a multinational company.

International Standards. The International Accounting Standards Committee has been working diligently these past years. It has been said that the committee has been successful so far because it has not attempted to deal with anything controversial. Yet, the committee could do us a disservice by producing a pronouncement that is superficially acceptable throughout the world but that would be misapplied. Accounting for leases illustrates this point. Could not any effective pronouncement be misinterpreted and misapplied, simply because accountants around the world view a lease transaction from different perspectives? Just as, in the accounting for marketable securities, accountants around the world have an entirely different perspective of the term "market."

The committee could make better use of its resources and perform a more valuable service if it concentrated its attention on broader areas. For example, International Accounting Standard No. 1 requires a company to disclose the accounting policies it has used in the preparation of the financial statements. This should be universally acceptable. It would also be appropriate to prepare a standard describing the disclosure that should appear in any statement prepared for commercial use. And the committee might devote its attention to the development of common, translatable terminology, so that accountants and financial people can be assured that they are communicating when they use

the search for a common denominator

their own country's technical terms. But I expect that the committee will come to this conclusion in any event, as it explores the more complex accounting issues on its present agenda.

Educating the User. As international accountants, we do the financial community a disservice if we let it believe that it may be possible to produce compatible accounting standards. In essence, we will be taking a responsibility that we are not equipped to fulfill, and we will be giving the rest of the financial community an excuse for abandoning its responsibility. What international accountants should be doing is educating the users of international financial statements to appreciate the fundamental, underlying differences in business conditions in different countries. Such users can then read the financial statements in the context of these differences.

We must admit to ourselves that we cannot remake the world. But we ought to be discussing at professional forums how these underlying differences affect our financial reporting. Further, we ought to develop reporting techniques which will enable an intelligent reader to understand how the results of a Japanese company might be compared with the results of an Italian company. In the Volvo example referred to above, the financial reports issued to different users need not conform to each other, but they should be reconcilable.

Consolidation vs. Disaggregation. Setting standards belongs of necessity to the future. But what of the problems of today? In order to deal with the problems of a disparate world, we must, I believe, challenge the consolidation approach.

The need to aggregate financial information in the United States stems from Accounting Research Bulletin No. 51 (Consolidated Financial Statements). This bulletin was issued in August, 1959, by the AICPA Committee on Accounting Procedures. It presumed that consolidated financial statements were more meaningful than separate statements, and that they were "usually necessary for fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies." The purpose of such statements was to present the entire group "essentially as if (it) were a single company with one or more branches or divisions."

The consolidation principles and techniques resulting from this bulletin have been in place since 1959. They must be challenged. They were grounded in the supposition that foreign subsidiaries were branches or temporary investments, that they would ultimately be liquidated and the proceeds repatriated. ARB 51 did not anticipate today's multinational corporation which makes long-term commitments of assets and operations in far-flung countries.

Is it reasonable to presume that the accounts receivable of a subsidiary operating in Brazil are the same as the accounts receivable of a subsidiary operating in France? Rules regarding collection, return of merchandise, warranty of defects, and so on may be completely different in the two countries. Can the aggregation of financial information of a company operating in those two countries and headquartered in the United Kingdom provide useful information to the reader of financial statements? Or would it be more meaningful to present the financial statements of the parent company and its domestic enterprises, as well as its *investments* in foreign countries?

Most investors would express little concern over the full consolidation of financial statements for an enterprise which has operations in both the United States and Canada, because they understand that business practices are similar. The same investors, however, would probably be more interested in the net equity position of the company's investments in wholly-owned subsidiaries in Mexico than in a full consolidation of Mexican operations with those in the United States.

The management of a multinational enterprise concerns itself not with the specific assets in the country in which it has located, but with its equity and its return on that equity. The most meaningful presentation, therefore, emphasizes this concern.

Standard No. 14 of the Financial Accounting Standards Board (Segment Reporting) begins to deal with the issue of disaggregation. SFAS No. 14 recognizes that businesses manage themselves not as monolithic entities but via segments arranged according to lines of responsibility. That is, foreign investment management is viewed as different from management of domestic enterprises, even within the same segment of a business.

It is my contention, therefore, that consolidated financial statements of multinational corporations should not include enterprises beyond the borders of the countries in which they are domiciled, except on an equity basis.

Disaggregation—The Effect

Equity Accounting. Investments in subsidiary companies abroad should be disclosed by country (presuming materiality), with the increment resulting from business operations year to year being shown on a single line in the statement of operations.

Readers of the financial statements of such an enterprise would see only the individual assets employed within the principal country in which the enterprise operated. The assets employed in countries abroad would be shown at their net investment value.

Risks taken by an enterprise in investing in a foreign country would be disclosed net, rather than spread throughout the financial statements and merged into other asset categories. Using the equity method would reduce the enterprise's need to use uniform accounting principles in order to achieve meaningful financial disclosure of results of operations and financial position. The equity approach would also force the reader of an international financial statement to understand something of international business and exercise his judgment in assessing the risks and determining the relative importance of foreign investments.

Translation. Disaggregation would also present a solution to the problems posed by SFAS 8. If it were unnecessary to consolidate subsidiaries of a multinational corporation, it would also be unnecessary to go through the artificial process of translating their financial statements into the currency of the parent. The business hedge of matching fixed assets to long-term debt would be more acceptable as an accounting standard, if only the equity of the investment abroad was shown in the parent financial statements. Such an approach would recognize the relative permanence of investments made abroad, rather than looking upon them as temporary, as did ARB No. 51.

It should be noted that Opinion No. 23 of the Accounting Principles Board, which was promulgated in April, 1972, recognized the permanence of foreign investments by allowing multinationals not to tax allocate foreign profits. This was based on the theory that repatriation of the investments was not likely to occur within a short period of time. The anomaly that exists between APB 23 and ARB 51 has never been reconciled. Disaggregation, in fact, recognizes that it may not be necessary, or possible, to bring financial statements of different countries to a common reporting denominator, but that it may be practical to aggregate financial results using a different methodology, one which does not need a common denominator.

Conclusion

While I believe that the accounting profession and multinational corporations must work together to develop a common understanding of measurement and reporting techniques, I also feel that existing nationalism and cultural differences will prevent the adoption of a universal system of accounting. Under the circumstances, while efforts of such groups as the International Accounting Standards Committee are useful and the work of the International Federation of Accountants will be beneficial, I do not believe that their pronouncements will be generally adopted, nor will a worldwide system be likely to evolve.

The reader of multinational financial statements must both work to understand these statements and be aware of the differences that now exist among them. He must also be willing to analyze the information fully in order to adequately understand it.

The efforts of the United Nations Conference on Trade and Development will probably not be widely accepted. The U.N.'s efforts appear to be a fishing expedition to develop information which will enable countries to tax enterprises within their borders. The information requested is in many instances nonaccounting in nature. Rather than simplifying international trade, it would vastly complicate the existence of most multinational corporations. The U.N.'s requirements, if adopted by many countries, will serve to discourage investments in those countries.

Since no utopian system is likely to evolve, a practical solution should be attempted. Users of financial statements will be best served by disaggregating the financial statements and presenting information in a manner which defines the commitment of resources and risks outside the home country's borders. Because of the differences that exist within auditing standards in different countries, a closer working arrangement between principal auditors and those to whom they refer work should be attempted.

If we accept less than utopia, we may, in fact, get the job done. And, while we may not be able to construct another Tower of Babel, we should rest comfortably in the knowledge that in 5,000 years of recorded history, no one else has been able to accomplish this feat, either.

This article is based on an address given by the author at the Third Jerusalem Conference on Accountancy.